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SUBJECT: RUSSIAN ENERGY GIANT RAO-UES BUYS ARMENIAN
ELECTRICITY DISTRIBUTION, IGNORES REGULATOR

REF: A) 04 YEREVAN 2769 B) 04 YEREVAN 2224

Classified By: Amb. John M. Evans for reasons 1.4 (b/d).

SUMMARY

11. (C) Russian energy giant RAO-UES has reportedly taken over Armenia's electricity distribution company, Electricity Networks of Armenia (ElNetArm), without formally seeking approval, as required by law, from Armenia's Public Services Regulatory Commission (PSRC) or Ministry of Energy. Despite the Energy Minister's past comments that he and the PSRC would frown on RAO-UES's bid to buy the distribution company (RAO-UES already controls 80 percent of generation), Ministry officials now seem at a loss, having been presented with a claimed fait accompli and the presumption of a blessing from higher up. In addition to deepening RAO-UES's present dominance in Armenia's electricity sector, the deal makes implementing market rules and competitive policies troublesome, thereby increasing the importance of effective regulation by the PSRC. The lack of regulatory process, if not corrected, casts doubt on the role and authority of Armenia's PSRC to provide such regulation. Post is considering whether a USAID assistance program to the PSRC should be continued; since the GOAM has evidently decided to ignore this institution, any further investment may be wasted resources. End Summary.

RAO-UES BUYS ARMENIAN DISTRIBUTION COMPANY

12. (C) Following eight months of talks, Inter-RAO, a subsidiary of RAO-UES, has reportedly purchased ElNetArm's parent company Midland Resources for USD 73 million, and taken full control of ElNetArm under a management contract. On July 5 Yevgeniy Gladunchik, the Director of ElNetArm, told us that as of July 1, RAO-UES had assumed control of the company. Gladunchik asserted that the deal had been structured so as to avoid regulatory hurdles. Although RAO-UES announced the purchase to its shareholders June 30, ElNetArm carefully denied that it was sold, asserting initially only that a management contract had been signed but later conceding that RAO-UES has become "the beneficiary of all shares." ElNetArm is trying to stress that the PSRC need not approve a sale of its parent company, Midland Resources, a subtlety lost on the local press and rejected by a local USAID contractor and the World Bank.

RAO-UES TRIES TO AVOID SEEKING GOAM APPROVAL

13. (C) Armenia's Energy Law, ElNetArm's license and ElNetArm's privatization contract (Share Purchase Agreement with the GOAM) provide that both the Public Services Regulatory Commission (PSRC) and the Ministry of Energy must approve any transfer of control of ElNetArm. According to those two bodies, neither ElNetArm nor RAO-UES formally notified any GOAM agency of the deal. Deputy Ministry of Energy Areg Galstyan told us that when he received informal information about the sale he told the company that "it was impossible because (they) must receive our permission." Despite ElNetArm's arguments, Galstyan persists: "Even in this case, they must receive our positive approval. We must ask them what happened." On July 8, the Ministry of Energy was preparing a letter to Midland Resources asking them to clarify the transaction to the Ministry of Energy and the PSRC. But Galstyan added, "Even if we now require them to give some sort of explanation to comply with the Energy Law, if this transaction is not good under our rules, I don't know what we can do."

MINISTRY: "NO MORE SPACE FOR RAO-UES IN ARMENIA"

14. (C) For several months, the Ministry of Energy had outwardly opposed the sale of further energy assets to

RAO-UES. "The Ministry does have an official policy to keep Russian control of the energy sector within its current limits.... There is no more space for RAO-UES in Armenia's Energy market" Deputy Minister Areg Galstyan told us in a February 23 meeting, alluding then to RAO-UES's bid to buy ElNetArm, (Ref A). At that time the Ministry expressed concern that it would be difficult to regulate the energy sector according to market rules if RAO-UES owned distribution assets as well as generation assets. In the last two years, RAO-UES took financial control of the Armenia Nuclear Power Plant (ANPP), five hydroelectric power plants in the Sevan-Hrazdan Cascade, and the Hrazdan thermal power plant. RAO-UES and its subsidiaries control 80 percent of Armenia's electricity generation capacity, as well as a distributor in Armenia's only paying export market, Georgia.

WORLD BANK CRITICIZES DEAL

15. (C) On Friday, July 8, the World Bank local office issued a strong statement of "serious concern" about the reported sale, demanding an "official and clear explanation from the authorities in Yerevan." The World Bank Country Head Roger Robinson publicly criticized the lack of a review and approval process, saying that the government's failure to confirm or refute the deal is "a sign of something that is not right." Robinson has urged both the PSRC and the Ministry of Energy to open a formal review of the deal "in an open and transparent way."

COMMENT: TIME FOR THE REGULATOR TO STEP UP

16. (C) The lack of transparency and process in this purported transaction contradicts the GOAM's Energy Law and its officially stated policy and goals--that an independent regulator will oversee a private energy sector on the basis of market rules. It is not clear if the Ministry of Energy and the PSRC would now approve or reject the deal if given the chance, as RAO-UES is a powerful player in Armenia's energy sector and probably did not make the deal without approval of someone in the GOAM. It is troublesome, however, that this deal appears to have been made without even the official notification of those who are charged to approve it.

17. (C) We look to the GOAM to correct the lack of process and transparently investigate the transaction and evaluate whether it is in the best interests of Armenia. Assuming that the transaction remains in force, the capacity of the PSRC to regulate the electricity sector directly and transparently will be more important than ever to check RAO-UES's monopoly power. If they fail to act, the PSRC and Ministry of Energy risk undermining their institutional credibility as regulators. We have made these points to both the Ministry of Energy and the PSRC. If, however, the GOAM takes no action, we are considering a range of actions, including cutting off technical assistance to the PSRC, to express our disappointment.

EVANS